Digital Systems & Technology

Applying IT to Sweeten Divestitures: The Seller Perspective

A lion's share of companies plan to divest in the next two years, according to industry gurus, but a significant number of divestment projects are delayed or deferred due to misalignment of the business strategy and the IT strategy. Here's how sellers can leverage IT as an enabler to achieve the business objectives that drive the divestiture agenda.

Executive Summary

In 2018, global merger and acquisition activity hit a new yearly high, surpassing previous records achieved on the event of the financial crisis over 10 years ago.[1] In 2020, organizations are still leaning heavily toward divestitures.

Corporate executives are seeking to take advantage of a climate informed by consumer confidence and historically low interest rates. In the U.S., the ongoing trade war with China is driving significant market consolidation that typically triggers mega-deals. Following the financial crisis, boards of directors are actively driving organizational portfolio reviews to focus on core growth areas. Activist investors are pressuring corporates to shed assets to free up a business's strongest assets for growth. The World Economic Forum notes that even established companies such as General Motors, Nestlé, Tiffany and P&G are targets of activist investors.[2]

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These forces are contributing to divestment activities across all industry sectors. A recent study by E&Y revealed that globally 84% of companies plan to divest in the next two years.[3] In the life sciences sector, 83% of companies are planning to divest portfolio assets, including deprioritized businesses. This report also contends that 60% of consumer businesses expect to initiate a divestiture over the next 12 months, while 82% expect to divest within the next two years.

A typical divestiture approach follows these high-level steps:

- Perform portfolio assessment and identify portfolios to divest.
- Agree on the divestiture strategy and align the IT strategy.
- Identify a buyer and manage the transition.

For successful delivery of divestiture projects, it is important to have high synergy between the business and IT early in planning, and to clearly define the business drivers and strategy for the divestiture agenda. The IT strategy should then be prepared to deliver on the same objectives and timeline. Divestitures are generally complex in nature. A one-size-fits-all type of IT solution approach will not always result in an outcome aligned to the divestiture objectives. Care should be taken to avoid the common pitfalls related to divestiture projects.

If not monitored carefully, IT separation costs could mount quickly and eventually stall or defer the divestiture. To accelerate the IT separation, consider technology implications. A clear understanding of regulatory requirements will help to develop an appropriate roadmap, and avoid severe delays later due to rework in addressing compliance concerns. Use of IT resources specialized in divestiture work will bring in a wealth of knowledge and experience to successfully deliver the IT separation. Moreover, use of a divestiture playbook will accelerate the project by applying checklists, tested methods and lessons learned from previous work.

Common divestiture strategies

Divestiture (also known as divestment or demerger) is a form of retrenchment strategy adopted by organizations that want to scale down the scope of their business, and usually involves eliminating a portion of their business. Companies may elect to sell, close, or spin off a strategic business unit, major operating division, or product line. Historically, divestment activity was initiated as a means to cut losses. However, more companies today are seeking to divest for strategic reasons and not because of a failure in the business. The increased frequency of portfolio reviews enables executives to identify areas of potential underperformance or emerging growth opportunities ahead of their competitors.

Active portfolio assessment closely drives retrenchment strategies for portfolios that are underperforming or misaligned to the core business. The typical pattern is to attempt to first turn around or pull back. This means pulling out of a market or closing a product line. An alternate retrenchment strategy is to divest that portfolio. A last resort option is liquidation, where assets of the business are sold.

Different types of divestiture strategies are broadly classified based on whether the original company wishes to hold an investment in the new entity or not. In a split-up, or split-off, the original company (or parent) has no investment in the newly created entity (or entities), while in a spin-off, or carve-out, the parent company retains an investment in the new entity. The relationship between various retrenchment strategies is illustrated in Figure 1.

The anatomy of divestiture

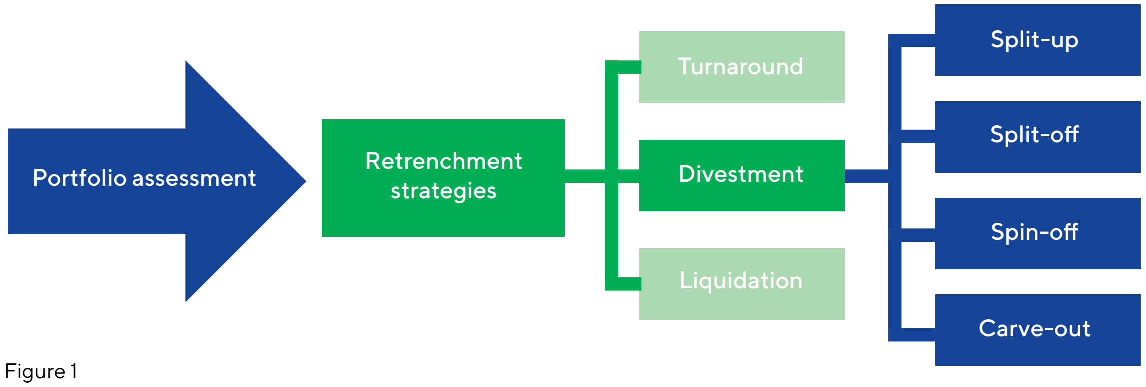

Figure 1

Historically, divestment activity was initiated as a means to cut losses. However, more companies today are seeking to divest for strategic reasons and not because of a failure in the business.

It is inevitable that in split-ups, duplicate technology solutions and support functions emerge, including those within the IT organization. A quick solution could be to replicate the original IT model, while an efficient solution could make use of some transformation themes and greenfield solutions.

The split-up

A split-up is where a company splits into two or more separately run companies. The original company completely loses its existence and stops trading its shares. The shares of the original company are exchanged for shares of the new company/companies. Split-ups are rare, generally done for strategic reasons or when the government mandates it. Companies with unrelated lines of business, growing at various rates, might choose to operate them separately to increase efficiency and to maximize profits. In this case, the new entities will have their own independent capital, management, development, product lines, manufacturing and sales.

Government regulations may also require a company to split up if it is shaping up to become a monopoly. In this case, the new entities will be required to be completely independent of each other to end the monopoly situation. The implementation of the competition law (or anti-monopoly law, or antitrust law) rarely allows for such a situation to arise these days.

Split-ups do not normally lead to mergers or acquisitions. The end state is usually known much earlier, which is the two or more independent businesses that were split up. It is inevitable that in split-ups, duplicate technology solutions and support functions emerge, including those within the IT organization. A quick solution could be to replicate the original IT model, while an efficient solution could make use of some transformation themes and greenfield solutions described later in this paper. Since the end state is more certain, an IT solution can be developed with reasonable accuracy. However, the biggest challenge probably is that the original parent company may not be able to offer overarching decisions for each split-up entity, which may have differing agendas. This can delay the IT separation program.

Case in point

The Hewlett Packard Company announced in October 2015 that it would split up into two new entities, HP Inc. and Hewlett Packard Enterprise.[4] A spin-off of the PC business division was already proposed earlier in 2011, which shareholders rejected. The business unit selling server hardware and software to enterprises was growing at a much quicker pace compared to the business unit selling desktops and printers to small- and medium-sized businesses, which was saturated and faced new competition from the mobile computing market. The separation was planned to occur through a pro-rata distribution to HP stockholders of 100% of the outstanding shares of Hewlett Packard Enterprise.

The IT strategy for split-offs must be carefully developed based on the strength of the portfolio identified for separation and its attractiveness to buyers. Unless the portfolio is performing poorly, the seller generally considers introducing some technology transformation to increase the prospects of identifying a buyer quickly.

The split-off

A split-off is a popular type of divestiture (also called demerger) in which a parent company sells assets, such as real estate, equipment or the entire subsidiary, to another party. The sale of assets typically involves cash and may trigger tax consequences for a parent company if assets are sold at a gain. The parent company does not hold any control or interest over the new entity, which usually leads to IT integration through an acquisition, when a buyer has been identified.

Although a business may be identified for split-off, the actual implementation of the divestment is not easy, especially where the business is underperforming. The management view may be divided on whether the performance of the portfolio will improve over time with change in demand for the product. The decision to divest might be perceived as failure of management and damaging to the public image. Identifying a buyer can prove to be challenging, and then a favorable price must be negotiated. Investors may not approve the proposal. These uncertain factors might cause the divestment strategy to revert to or change from what was announced originally.

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For highly uncertain portfolios, the seller might choose to cut their losses by refraining from investing heavily in technology refreshes with the hope that the buyer already has an efficient target model and technology into which the added portfolio will integrate. Cutting back on capital expenditure (CapEx) by considering operating expenditure (OpEx) models such as cloud adoption might achieve a balance between cost and value of the portfolio. Implementation of application rationalization, data separation, mitigation of the European Union's General Data Protection Regulation (GDPR) risks and planning of separation for manufacturing units and branch offices will significantly increase the appeal of the split-off business to the buyer.

Case in point

Vista Outdoor Inc. split off its Savage Arms and Stevens firearms brands.[5] It sold the divested company in July 2019 for a total purchase price of $170 million, comprised of $158 million paid at closing and $12 million to be paid upon maturity of a five-year seller note issued by the buyer. At closing, Vista Outdoor received gross proceeds from the divestiture of $158 million. Vista Outdoor will use the net after-tax proceeds of the sale to repay outstanding indebtedness.

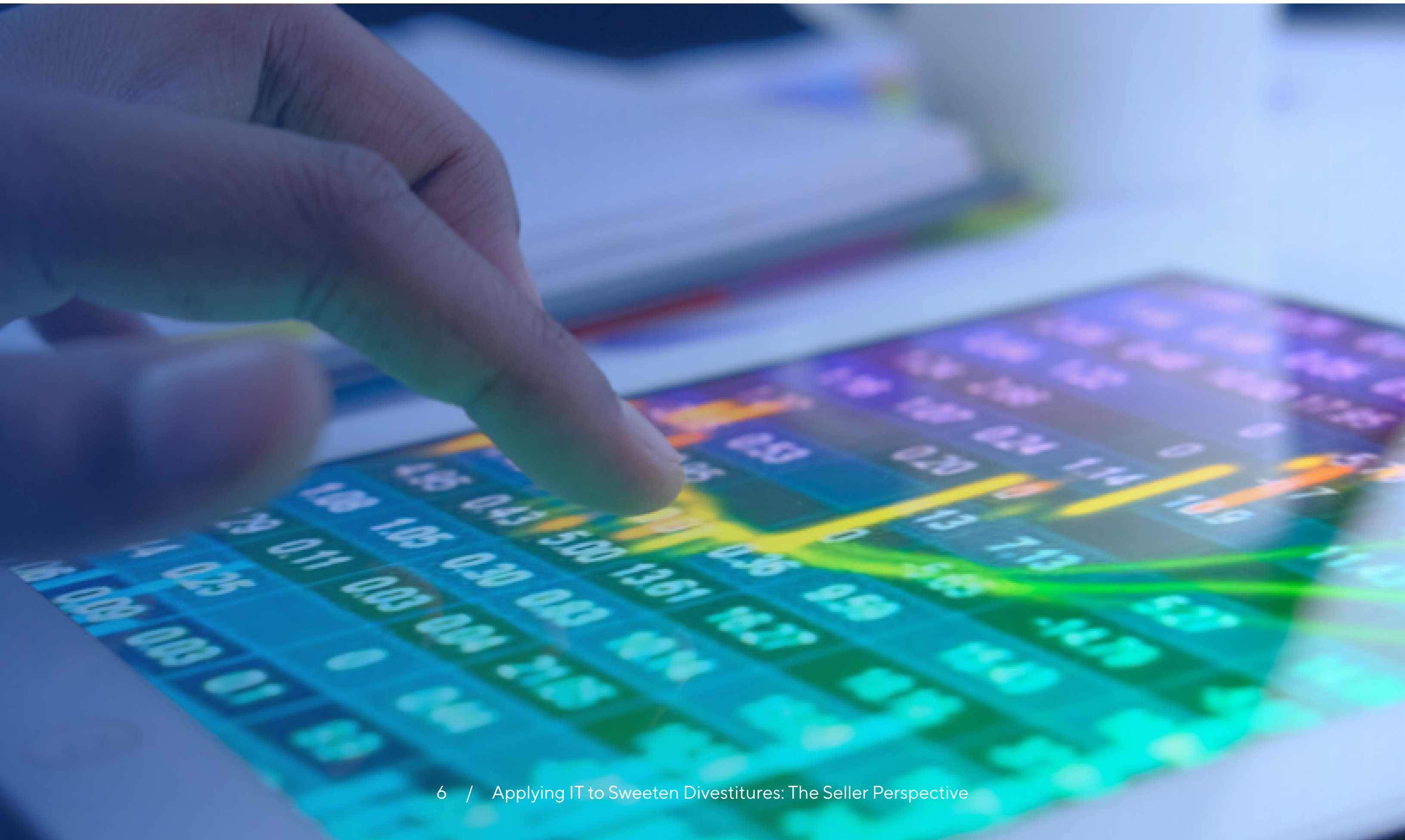
The spin-off

A spin-off (also called spin-out or starburst) is the creation of a new company by distribution of new shares of the parent company to existing shareholders. Rather than selling shares in the business unit publicly, current investors are given shares in the new company. This type of divestiture is non-cash and has tax benefits. The new entities are expected to be worth more as independent entities than as parts of a larger business. The new entity is now an independent company with its own shareholders, though the original parent company may still own an equity stake. This might lead to IT integration later through a merger if a deal is agreed on with an interested company.

The IT strategy for separation directly depends on the business strategy for the end state. If the new entity will head for a merger soon after separation, then it will be an efficient move to consider the IT separation project at the source and the subsequent IT integration project at the target, under one combined project plan, which will drive cost optimization. To achieve regulatory compliance related to direct integration, the use of temporary landing zones could be considered. Point of sale and office branches migration will be a key part of the planning for separation.

Case in point

In February 2019, GE announced a spin-off of its Transportation Systems Holdings Inc. ("SpinCo").[6] Immediately following the spin-off, SpinCo merged with a subsidiary of Wabtec Corp. GE received approximately $2.9 billion in cash as well as shares of Wabtec common stock and Wabtec nonvoting convertible preferred stock that together represent an approximately 24.9% ownership interest in Wabtec. Under this modified structure, where cash was issued in lieu of shares, the spin-off will be considered a taxable dividend for U.S. federal income tax purposes.



The core infrastructure services and hosting services might be a shared service offered by the parent. However, it will be prudent to complete the application rationalization (and the separation of data, identity management and branches) to easily move to total divestment in the future, if desired. The IT strategy will eventually rely on the business strategy to provide direction for planning.

The carve-out

In a carve-out (also called equity carve-out), a parent company sells minority equity in its subsidiary to the public in the stock market through an initial public offering (IPO). This option is used widely to raise capital. The final goal of the company might be to divest totally, which could lead to a merger or acquisition, but this typically takes several years.

This type of divestiture strategy may be adopted if a single buyer for the entire business is not available or if the parent company wants to maintain some control over the business unit. It may also be adopted if the two business units are so tightly integrated that severing the connection might lead to financial losses. The new entity will have its own board of directors, financial accounting and investors. The parent company retains a controlling interest in the new company and offers strategic support and resources to enable it to succeed. Equity carve-outs are tax-free transactions that involve exchange of cash for shares.

The carve-out most likely will have shared resources and support from the parent company, which may choose not to duplicate all support functions to avoid higher operating costs. The carve-out might benefit from group license options provided by the parent. Additionally, the core infrastructure services and hosting services might be a shared service offered by the parent. However, it will be prudent to complete the application rationalization (and the separation of data, identity management and branches) to easily move to total divestment in the future, if desired. The IT strategy will eventually rely on the business strategy to provide direction for planning.

Case in point

Eli Lilly and Company announced in July 2018 that it had completed its strategic review of Elanco Animal Health.[7] It decided to go for an IPO of a minority ownership stake in Elanco as a separate company, with Lilly retaining an 80.2% ownership interest in Elanco and continuing to consolidate Elanco in reporting its financial results. The driver of the carve-out was to allow Elanco to efficiently deploy its resources to growth opportunities that best serve its customers, while Lilly would have greater focus on the human pharmaceutical business.

The divestiture was initiated as an exchange offer where Lilly shareholders could opt to exchange all, some, or none of their shares of Lilly for shares of Elanco. The exchange offer would be considered tax-free for participating Lilly shareholders in the United States, except with respect to cash received in lieu of fractional shares.

Divestiture drivers

Which triggers prompted your most recent major divestment? Select all that apply

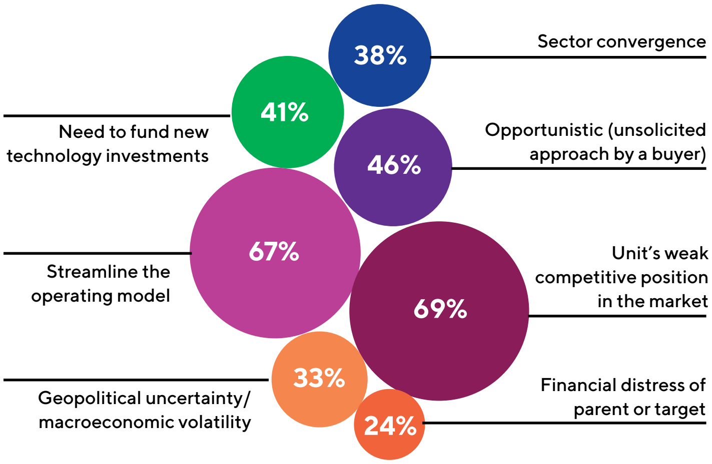


Figure 2

Divestiture triggers

The shift to more frequent portfolio assessments is on the rise. The speed of disruption is forcing executives to examine their portfolio more frequently, for risks and opportunities. More companies are performing portfolio reviews quarterly, rather than annually, in our experience. Executives are inclined to drive capital recycling to invest into growth areas, and divest underperforming assets, because allocating capital to similar or connected areas enhances value. These days, a divestiture most commonly results from a management decision to cease operating a business unit because it is not part of a core competency. This trend was called out in the recent E&Y survey (see Figure 2).[8]

"Streamline the operating model" and a "unit's weak competitive position" are leading reasons for divestments. "Unsolicited approach by a buyer" is closely following the top divestment triggers. Activist pressure is fueling more regular assessments and reshaping of portfolios. "Sector convergence" and the "need to fund new technology investments" are directly related to costs of running IT. Executives are generally inclined toward spend on IT that is common across portfolios to optimize costs, but will often shy away from individual portfolios that have significant upcoming costs to refresh IT. Knowledge of the divestiture strategy and the management's appetite for IT spend will allow appropriate IT solutions to be developed for the divestment.

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Transformation themes

Technology transformation can increase the interest in the portfolio being divested since buyers know that they can defer expenses related to technology refresh. A portfolio that runs on modern technology is perceived to be of greater efficiency, hence greater value. An increased potential to close a deal means the divestiture objectives can be quickly met. Some of the common areas where technology transformation is evidenced include hosting, workplace, business intelligence and analytics, and enterprise applications.

Cloud adoption for hosting

Record divestiture activity is driving new cloud adoption techniques for digital transformation. Two leading strategies available to corporations for progressing with divestitures are the greenfield strategy and the brownfield strategy.

With a greenfield strategy, a new infrastructure is built in the target hosting location. The workplace services, foundation services and enterprise applications are transferred to this new infrastructure in a phased manner. The target hosting strategy can be either all public cloud, all private cloud, or a mixture in a hybrid model.

With a brownfield strategy, on the other hand, only some key functions are moved from one organization to the other. The target hosting strategy tends to be hybrid cloud. The proprietary systems that are difficult to replicate or those that hold particularly sensitive information are retained on-premise while more modern and customer-facing systems are moved to the public cloud.

Demand for the greenfield strategy is increasing not only as an enabler for the divestment transition. Rather, industries are also seeking to take advantage of disruptive technologies to drive accelerated benefits for business growth areas. Cloud, mobile computing and big data are key focus drivers for the divestment programs that will achieve both cost savings and core growth. An apples-to-apples technology transition for the divestiture cannot sustain the immediate divestiture business case. Tactical and strategic technology adoptions are required, instead, to secure the necessary business case.

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Workplace transformation

Cloud adoption for IT carve-outs typically address the need of large workplace transformations. They include IT elements related to user identity, user profiles, messaging and collaboration platforms. In large workforce-based transitions such as manufacturing and production-based operations, there are conflicting drivers: boosting cost efficiency and generating transformation opportunities.

In large workforce-driven enterprises where the baselines are on-premise only, there is significant waste in license and inefficiencies in user experiences. In such enterprises, a divestment program is presented with opportunities to drive operational savings by addressing license rationalization and right-sizing of user personas. Further savings can be achieved through a cloud-first adoption built out from the active directory and system management systems to office productivity and collaboration systems.

In our experience, global manufacturing divestitures are best placed to utilize Office 365 E3 licenses with centralized services for the majority of user personas. However, business planning and finance-oriented personas benefit from E5 plans that offer additional business analytics services.

Workplace transformations are typically key focus areas for enterprises undergoing divestures with much focus given to establishing a new brand identity. Cloud adoption further strengthens their ability to differentiate the new brand entity. A new IT service is also created to look after the workplace services and tends to be via a shared IT service with low to medium user satisfaction.

Digital workplace services are typically made available through Microsoft Azure, AWS Workplace, Google Cloud Platforms, Citrix and VMware platforms.

Adoption of business intelligence and analytics

Business intelligence and analytics is the next core disruptive technology adoption influencing divestment agendas. In the consumer businesses, the drive to divestment is influenced by desire to make informed decisions on key offerings. To keep pace with rapidly changing consumer behavior, decision-support systems require tuning and/or an overhaul. The divestment entity while under group control is the ideal venture for early option of business intelligence and analytic techniques.

Historical and live data management are key attributes of the divestment activity, especially to keep pace with GDPR changes. Where the transaction agreements enable a clone of the data warehouse with data scrubbing techniques, the landing zone can be public cloud platforms – such as Google Big Query, Amazon Redshift or Microsoft Azure data warehouse backed by a data lake for storage. To drive agility, earlier adoptions of the new IT divestment operation (such as those on Day 1) seek to improve data trending and reporting techniques.

> For heavily integrated shared services, the IT separation of the major applications needs to be demonstrated at the due-diligence stage. This may provide proof of a separate general ledger to release the three years of accounting records for the prospectus.

Re-platforming of key enterprise applications

Another theme consistent in digital transformations for divestments is the re-platforming of key enterprise applications such as enterprise resource planning (ERP), point of sales system or asset management.[9] For heavily integrated shared services, the IT separation of the major applications needs to be demonstrated at the due-diligence stage. This may provide proof of a separate general ledger to release the three years of accounting records for the prospectus. This major application separation is achieved without moving the workplace services that are retained as an interim transition arrangement with the incumbent IT service.

Rarely will the baseline analysis of these key systems result in a pure re-host recommendation. The major applications tend to have an inherent operational debt. The transformation activity therefore requires either:

- Remediation of out-of-date platforms (operating systems and hardware).
- A major application release plan that inherently moves the application to new platforms.
- A service improvement plan to optimize performance and scale.

The majority of enterprise architects will have already assessed public cloud adoption for major enterprise applications – the divestment plan is the trigger that forces the adoption. There are multiple ways to adopt the public cloud for such applications. These include infrastructure as a service (IaaS) or platform as a service (PaaS) options on public cloud providers such as Microsoft Azure, Amazon Web Services, Google Cloud Platform, IBM Cloud and Oracle Cloud, or software as a service (SaaS) using enterprise applications such as Infor and Epicor. It is therefore necessary to carry out analyses on a case by case basis.

An efficient move would be to bring in experts in this type of work who can accelerate the work by using playbooks and experience from the field and by introducing tools. Knowledge on the ground cannot be replaced by tools, and hence internal IT will be engaged to fill in gaps of knowledge.

Lessons from the field

Over the years of executing IT separation projects for divestitures, we have spotted some consistent patterns that have emerged, which can be addressed early into the implementation to avoid delays later. These include:

- **Divestitures are far more complex than initially perceived.** The complexity involved in divestitures are often highly underestimated. Fairly soon after the IT separation project is approved and funded, it becomes evident that things are not as straightforward as they are with internal projects. This is not just another regular IT project. Typical IT decisions about upgrading to the most current systems are not always the best move. Alignment of the IT strategy to the business strategy often requires a proper understanding of financials and IT. To ensure an accelerated separation, it is vital that specialists handle this work.

  The typical process of discovery, commencing with business processes and application discovery, usually does not meet separation timelines. The complexity involved in the data and interface separation (especially with SaaS providers) is often highly undermined, which forms the core part of what distinguishes divestment migration from workload migration. Also, the increased workload on Internal IT could cause degradation of the quality of service delivery to the original parent company.

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- **Decisions are usually the bottleneck.** Once a divestiture is announced, there is a generally considerable amount of confusion within common support teams about who will remain with the parent and who belongs to the divested business. This leads to uncertainty about whether a resource is still authorized to make decisions about the new company. Contractors and vendors who might have supported decision-making until the point of the announcement suddenly back off because they are unsure of how to proceed. Added to this is the human resistance to change, which introduces resistance to moving forward with the plan.

  To ensure clarity of roles, a separation project team should be formed, defining the role of each member. A separation governance panel (consisting of senior management) should be formed for separation change reviews and to quickly clear obstacles. Inclusion of senior members adds emphasis to the importance of this work.

- **One size does not fit all.** It is generally not a good idea to use one IT strategy for all divestiture projects. It is common for organizations to consider IT separation as the end state, overlooking the fact that there could be one more step of IT integration if the deal continues into a merger or acquisition. In such cases, an interim state should be considered that does not cover all the aspects required for a total separation. For example, total separation of IT too early might introduce duplicate costs in staffing, licensing and hosting, which could destroy the business case if a buyer cannot be identified quickly. The end result of a divestiture cannot always be certain at the point of the announcement. The IT strategy should consider such a risk if relevant, and offer some flexibility if this needs to be changed later.

Each divestiture has a unique set of requirements defined by the divestiture strategy and the workstream interdependencies. A cost-effective IT separation strategy can be developed by considering both the business and technology aspects of the portfolio being divested. Acceleration can be introduced by considering common strategies only as templates that need to be tailored to align to the divestiture objectives.

Looking ahead

Active portfolio assessment will continue to remain a priority for businesses and the divestment activities will continue to increase in 2020 —and beyond. However, once companies decide to divest, the complex separation process requires far more preparation than sellers often expect.

Preparation of the IT strategy is best left to the subject matter experts to lead.

Early planning and use of a divestiture playbook will significantly increase the likelihood of accelerated, cost-effective and successful IT separation that accomplishes the business objectives.

Endnotes

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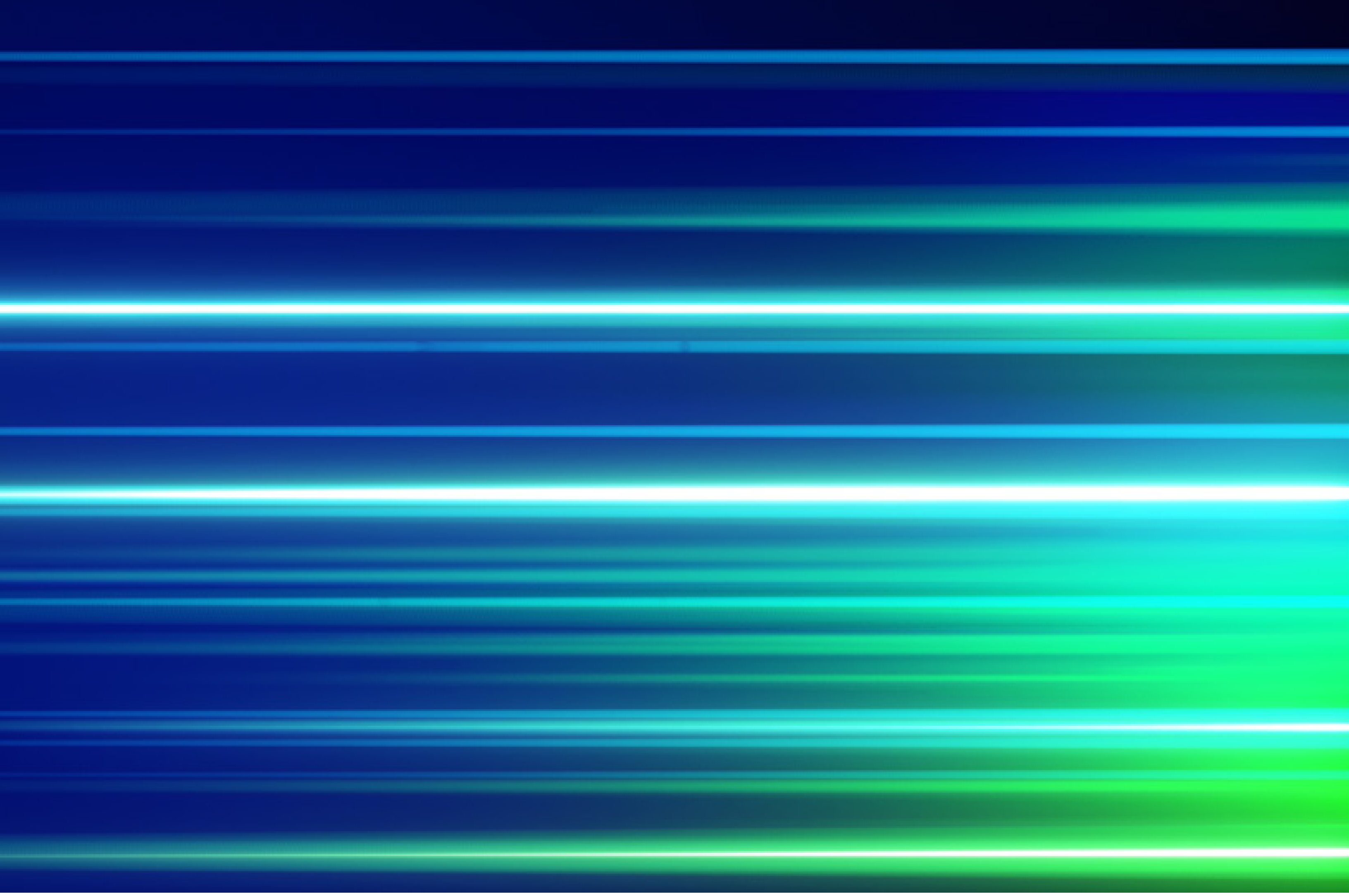

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